

## IRS Attempts to Reclassify S Corporation Shareholder Loan Repayments as Wages

In 1981 Scott Singer created Scott Singer Installations Inc., (SSI) a corporation in Florida. SSI is taxed as an S corporation. The business engaged primarily in servicing, repairing, and modifying recreational vehicles. SSI also sold Kraftmaid cabinets used in the construction of homes. Scott was the only shareholder of SSI.

Business quickly grew and Scott moved the operations to Colorado in 1999. Over the next few years Scott borrowed money from banks, family, and friends to expand the business, totaling approximately \$1,000,000. He lent the borrowed money to SSI, showing it as a loan on the books as Loans From Shareholders.

Scott worked fulltime for SSI. Business took a downturn and started losing money (\$103,305 for 2010 and \$234,542 for 2011). During these years SSI paid \$181,872 of Mr. Singer's personal expenses including meals, groceries, care payments, retail purchases, and payments on his house loans. SSI did NOT claim a deduction for any of these payments. It reported them on its books as repayments on the Loans From Shareholders.

SSI occasionally employed a service technician, two laborers, and an individual to help with internet sales. SSI filed Forms 940 and 941 and paid employment taxes on wages paid to each employee. However SSI did not show any wages paid to Scott Singer.

IRS determined the \$181,872 paid to Scott should be considered wages subject to employment taxes.

The issues before Tax Court are: "Is Scott an employee of SSI?" And "Were the payments made on behalf of Scott's loan repayments?"

Tax Court looked at the various characteristics that exist with loans, such as written documentation, reasonable interest rate, repayment schedule, and expectation of being repaid. Tax Court determined that roughly \$646,443 of advances to SSI that Scott had made through 2008 appeared to be loans and that his intentions of repayments were reasonable. However, the roughly \$513,099 of advances Scott made to SSI in 2009 and later years did not appear to be loans, especially since SSI's financial difficulties made it unlikely the loans would ever be repaid. Therefore these advances should be classified as capital contributions.

The Court also looked at the payments. The amounts were fairly consistent each month, similar to what a creditor would normally receive AS OPPOSED to various amounts which is what would be paid to an employee if hours worked varied.

The Court also determined there was a sufficient amount of the pre-2009 loans still in existence to justify the treatment of the payments to be loan repayments as shown on SSI's books. Thus the Court ruled that none of the payments were reclassified as wages.

This case is appealable.

[Editor's note: We find the results a little surprising in that the Court did not look at the ordering rules for payments. These ordering rules generally require wages to be kept current, then creditors to be kept current, and finally distributions to owners. In this case Scott held all three hats: employee, creditor, and owner. The employee Scott was not paid even though he provided services. Our understanding of the ordering rules say Scott the employee should have been paid a reasonable pay before Scott the creditor received loan repayments.]

Scott Singer Installations Inc., TC Memo 2016-161, August 24, 2016

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